G. UPDATE ON CHURCHES

1. Introduction

This topic provides an overview of the developments during the past year in litigation and administration that affect churches. The developments highlight the complex and sensitive nature of the Service's task of fairly administering the federal tax law as it applies to churches.

2. Litigation Developments

In 1989, the Supreme Court issued an opinion that may have a significant impact on the area of charitable contributions to religious as well as nonreligious institutions. In Hernandez v. Commissioner, No. 87-963 (June 5, 1989), the Court, in a 5-2 decision, ruled that fixed charges paid to Scientology branch churches for auditing and training sessions were not deductible as charitable contributions under IRC 170.

Scientologists believe that an immortal spiritual being resides in every person. The Church of Scientology claims that its auditing sessions are directed toward increasing its members' awareness of this spiritual dimension. During these sessions, a Church official (known as an "auditor") identifies a participant's areas of spiritual difficulty by measuring skin responses on an electronic device, the E-meter, during a question and answer session. The Church also offers its members courses known as training in which participants attempt to qualify as auditors.

The Church has established a system of mandatory fixed charges which are based on an auditing or training session's length and level of sophistication. This system is based on a doctrine of the Church known as the "doctrine of exchange," which states that any time a person receives something, something must be paid back. The proceeds from these sessions are the Church's primary source of income. Participants are given a 5% discount for any advance payments made for these sessions. The Church also often refunds unused portions of prepaid fees, less an administrative charge.

The Service disallowed deductions for these payments taken by Robert Hernandez, Katherine Jean Graham and several other members of the Church on their federal income tax returns as charitable contributions under IRC 170. The Tax

Court consolidated for trial the cases of Graham and two other church members. Hernandez and several other members agreed to be bound by the findings of that trial. The Service stipulated before the trial that the branch churches of Scientology are religious organizations entitled to receive tax-deductible charitable contributions solely for the purpose of deciding the merits of the charitable contribution issue in this litigation.

The Tax Court held that because Church members had received consideration for their fixed fee payments, namely, "the benefits of various religious services provided by the Church of Scientology," the payments were not deductible gifts. Graham v. Commissioner, 83 T.C. 575 (1984). Church members appealed the Tax Court decision to all of the U.S. Courts of Appeals except the Federal Circuit. The Circuit Courts issued conflicting decisions. In disagreeing with the Tax Court, some Circuits determined that requiring a payment as a condition of participation in a church's essential religious activities does not result in a quid pro quo arrangement since there is no recognizable economic benefit other than spiritual gain. The Supreme Court granted certiorari in two of the cases to resolve the issue.

In a majority opinion written by Justice Marshall, the Supreme Court held that the Church members' payments do not qualify as "contributions or gifts" since "these payments were part of a quintessential quid pro quo exchange: in return for their money, petitioners received an identifiable benefit, namely, auditing and training sessions." Citing United States v. American Bar Endowment, 477 U.S. 105, 91 L Ed 2d 89, 106 S Ct 2426 (1986), the Court focused on the external features of the transaction, not the motivations of individual church members. The Court found that:

The Church established fixed price schedules for auditing and training sessions in each branch church; it calibrated particular prices to auditing or training sessions of particular lengths and levels of sophistication; it returned a refund if auditing and training services went unperformed; it distributed "account cards" on which persons who had paid money to the Church could monitor what prepaid services they had not yet claimed; and it categorically barred provision of auditing or training sessions for free. Each of these practices reveals the inherently reciprocal nature of the exchange.

The Court rejected the Church members' argument that this quid pro quo analysis is inappropriate under IRC 170 in this instance since the benefit a taxpayer receives is purely religious in nature. The Court found no indication in the

legislative history of IRC 170 that Congress intended that there be a special preference for payments made in the expectation of gaining religious benefits or access to a religious service. In fact, the Court contended that the members' deductibility proposal would expand the charitable contribution deduction far beyond what Congress has provided. Such forms of payments as tuition payments to parochial schools might be viewed as providing a religious benefit or as securing access to a religious service. Finally, the Court states that determining the deductibility of a contribution based on its religious nature might result in entanglement between church and state since the Service and the reviewing courts would be required to differentiate "religious" benefits from "secular" ones.

The Court also rejected the Church members' constitutional claims, concluding that IRC 170 passes constitutional muster under both the Establishment Clause and the Free Exercise Clause of the First Amendment. The Court concluded that the fact that the Service may have to ascertain what portion of a payment for a religious benefit is a contribution and what portion is a purchase in some cases will not necessarily create entanglement problems. Instead of using a benefit-focused valuation, the Court indicated that a Service inquiry into the cost (if any) would be an appropriate method of valuation where the economic value of a good or service is elusive. However, no argument was raised that any portion of the payments exceeded the value of the acquired services so that there were valuation questions present.

The Church members' final assertion that disallowing their deductions is at odds with the Service's administrative practice of allowing taxpayers to deduct payments made to other religious institutions in connection with certain religious practices was also not accepted by the Court. The Court stated that it was unable, in the absence of an actual factual record, to determine whether the Service had correctly applied a quid pro quo analysis with respect to religious practices involved in other cases.

In a dissent joined by Justice Scalia, Justice O'Connor stated that the Service's disallowance of these deductions was "a singular exception to its 70-year practice of allowing fixed payments indistinguishable from those made by petitioners to be deducted as charitable contributions." Justice O'Connor emphasizes the fact that unlike the denial of a deduction for religious school tuition up to the market value of the secularly useful education received, the Service's position is not based upon the contention that a portion of the knowledge received from auditing or training is of secular, commercial, nonreligious value. The

Service denies deductibility based solely on a quid pro quo analysis even though the quid is exclusively of spiritual or religious worth.

Justice O'Connor also argues that it has been the Service's position since 1919 to allow the deduction of fixed payments similar to the ones taken by the Scientologists as charitable contributions. In ARM 2, 1 C.B. 150 (1919), the Service held that pew rents, assessments, church dues, and the like are simply methods of contributing although in form they may vary. The Service concluded that such fixed payments were contributions to the church. The Service reaffirmed this position in Rev. Rul. 70-47, 1970-1 C.B. 49. Rev. Rul. 78-366, 1978-2 C.B. 241, is also cited since it provides that mass stipends as fixed payments for specific religious services are deductible. Given the Service's position on these and other cases, Justice O'Connor concludes that denial of these deductions is violative of the Establishment Clause because it involves the differential application of a standard based on impermissible differences drawn by the Government among religions.

The Hernandez holding appears to be a logical extension of the Court's holding in Texas Monthly, Inc. v. Bullock, 109 S. Ct. 890 (1989), a case the Supreme Court decided earlier in 1989. In the Texas Monthly case, the Court struck down a Texas statute as violating the Establishment Clause since it exempted church organizations from sales and use tax on religious publications without providing any comparable exemption on publications of secular charitable organizations. Similarly, the Court in Hernandez refused to allow tax benefits to be derived from payments to religious institutions for religious benefits since comparable tax benefits would not be permitted in similar quid pro quo arrangements involving nonreligious benefits provided by other charitable organizations. These Supreme Court cases reflect the Court's ongoing effort to insure that the tax laws do not promote religion over nonsecular purposes.

The Supreme Court also decided to review a case, Jimmy Swaggart Ministries v. Board of Equalization of California, 204 Ca. App. 3d 151 (Cal. Ct. App. Aug. 29, 1988), cert. granted, No. 88-1374 (U.S. Apr. 17, 1989), which involves the application of a state sales and use tax on the sale of religious materials. The California Court of Appeals had ruled that a California tax on the sale of religious books, tapes, and other merchandise by Jimmy Swaggart Ministries is valid since it does not violate the Free Exercise or the Establishment Clauses of the Constitution. On October 31, 1989, the Court heard oral arguments in this case.

In another Scientology case, the Supreme Court upheld a District Court order that conditioned the enforcement of an administrative summons sought by the Service for documents sealed by the California Superior Court in Church of Scientology v. Gerald Armstrong, No. C 420 153 (Cal.Super.Ct.), on the stipulation that the Service not deliver the information to another government agency except in connection with criminal tax prosecution or with the Court's approval. The Court remanded the case in part, however, based on a finding that the Ninth Circuit Court of Appeals erred in its review of an issue regarding the crime-fraud exception to the attorney-client privilege raised by the Service in the case. See United States v. Frank S. Zolin, Church of Scientology of California and Mary Sue Hubbard, No. 88-40 (June 21, 1989).

As discussed in last year's CPE article on this subject, the Supreme Court had remanded the Abortion Rights Mobilization (ARM) case to the Second Circuit Court of Appeals for a determination of whether or not the District Court had subject matter jurisdiction of the underlying action. The Second Circuit, in an opinion written by Judge Cardamone, has held that ARM and the other plaintiffs that brought the action do not have standing to challenge the tax exempt status of the United States Catholic Conference (USCC) and the National Conference of Catholic Bishops (NCCB). See U.S. Catholic Conference, et al. v. Abortion Rights Mobilization, Inc. No. 86-6092 (2d Cir. Sept. 6, 1989). The Court indicated that a theory for standing that it named "competitive advocate standing" posed the closest legal question in the case. The theory is based on plaintiffs' claim that the Service is unequally enforcing the Code to their detriment when it allows the Catholic Church to campaign without losing its tax exempt status and allows the Church's donors to deduct their contributions. The plaintiffs argued that the Service's failure to enforce the Code "constitutes an illegal, unfair and unconstitutional distortion of the political process by the government. ..." The Court found, however, that the plaintiffs lacked the requisite particularized injury in fact to support this claim since it did not engage in electioneering itself in competition with the Catholic Church. The Church's alleged advantage did not adversely handicap the plaintiffs.

Judge Newman in dissent disagrees with this finding of the Court on the grounds that, if the allegations are true, "the plaintiffs will have been seriously injured both in the eyes of the law and in the real world of political advocacy by the significant advantage currently being enjoyed by the Catholic Church as a result of governmental action that violates the tax laws." Judge Newman further argued that the plaintiffs should not be denied standing to challenge a violation of law because they obeyed a requirement of an act of Congress.

A requested rehearing on the issue of standing made by ARM to the Second Circuit was denied. See United States Catholic Conference, et al. v. Abortion Rights Mobilization, Inc., No. 86-6092 (2d Cir. Oct. 4, 1989).

In the area of church schools, it appeared that the Service's position that churches directly controlling or supervising a private school must demonstrate that the school is operating in a racially nondiscriminatory manner in order to obtain or maintain their exempt status as set forth in Rev. Rul. 75-231, 1975-1 C.B. 158, and G.C.M. 39754 (September 8, 1988) might be tested in a declaratory judgment suit filed by Second Baptist Church of Goldsboro in the Tax Court. On July 11, 1989, the Tax Court announced in a stipulated decision, however, that the Second Baptist Church of Goldsboro and the Service had reached an agreement that provided that the Church was not tax exempt during 1983, 1984, and 1985. See Second Baptist Church of Goldsboro v. Commissioner, T.C No. 03009-88 (July 11, 1989).

The Tax Court also decided other cases during the year involving the application of federal tax law to churches. In Truth Tabernacle Church, Inc. v. Commissioner, T.C. Memo. 1989-451 (Aug. 24, 1989), the Court reversed the Service's revocation of the Church's tax exempt status. The Court found that the Church's primary activities consisted of various worship services, the performance of sacerdotal rites, and other church related activities. The Court disagreed with the Service's finding that the facts and circumstances of the case, including the fact that the minister's only compensation was in the form of the use of a car and an apartment, indicated that unreasonable compensation was inuring to the minister.

The Tax Court upheld, however, a ruling by the Service that the First Church of In Theo did not qualify as a church under IRC 170(b)(1)(A)(i) because it did not provide sufficient associational activities for its members. The Church did, however, qualify for exempt status under IRC 501(c)(3). See First Church of In Theo v. Commissioner, T.C. Memo. 1989-16 (Jan. 10, 1989).

In Tweeddale v. Commissioner, 92 T.C. No. 31 (Mar. 22, 1989), the Tax Court held that a minister of the Basic Bible Church of America, a "mail-order" church, was liable for section 6661 penalties for underpayment attributable to a substantial understatement of tax liability. This ruling buttresses the Service's position published in Rev. Rul. 89-74, 1989-21 I.R.B. 21 (May 22, 1989), that sham churches such as those described in Rev. Rul. 78-232, 1978-1 C.B. 69, and Rev. Rul. 81-94, 1981-1 C.B. 330, are "tax shelters" that are not eligible for the "adequate disclosure" exception of IRC 6661(b)(2)(B)(ii) when tax is understated.

In King Shipping Consum, Inc. v. Commissioner, T.C. Memo. 1989-593 (Oct. 31, 1989), the Tax Court found that an organization claiming to be a church was actually organized and operated for purposes of smuggling and distributing illegal drugs for profit and, therefore, not a tax-exempt organization.

3. Administrative and Legislative Update

The Service has revised IRS Manual Supplement 7(10)G-53 (December 2, 1988) for the purpose of extending the guidelines for the retention and storage of documents requested in interrogatories served on the Service by ARM. The documents to be retained pertain to the tax exempt status of USCC, NCCB, or any of their subordinate groups under the IRS group exemption number 0928.

IRM 7(10)69-5 has also been revised to reflect provisions of the Technical and Miscellaneous Revenue Act of 1988 requiring that taxpayers, including churches, be provided an explanation of the rights and responsibilities of taxpayers and the Service during the examination process. The procedures now require that Publication 1, Your Rights As a Taxpayer, must be included with all initial contacts.

The Service continues to provide to the Subcommittee on Oversight of the Committee on Ways and Means quarterly reports on the Service's examination and collection actions of media evangelists. The Subcommittee's Chairman, Representative Pickle (D-TX), placed one of the Service's reports in the Congressional Record (Congressional Record, Feb. 9, 1989).

4. Conclusion

The courts continue to closely scrutinize the Service's treatment of churches. The Supreme Court, in particular, decided two cases in 1989, the Hernandez and Texas Monthly cases, that may have a broad range impact on the Service's administration of the tax laws applicable to churches. Whether these court developments will be the impetus for changes in the tax laws is uncertain.

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1990 UPDATE

Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional Education Technical Instruction Program textbook for 1990. As a result, what you have already read

contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

G. UPDATE ON CHURCHES

1. Litigation Developments

In a case involving the deductibility of contributions under IRC 170, Harold Davis, et ux. v. United States, 110 S.Ct. 2014 (1990), the Supreme Court held that funds transferred from petitioners to their two sons while they served as full-time, unpaid missionaries for the Church of Jesus Christ of Latter-day Saints were not deductible as charitable contributions since the parent's payments were not "to or for the use of" the Church within the meaning of IRC 170. Based on the legislative history which added the phrase "for the use of" to IRC 170, the Court concurred with the Service's longstanding position that the phrase "for the use of" intended to convey a meaning similar to the phrase "in trust for." The Court could find no evidence that petitioners transferred funds to their sons "in trust for" the Church since the Church lacked sufficient possession and control of the funds.

The Supreme Court also decided a case, Jimmy Swaggart Ministries v. Board of Equalization of California, 110 S.Ct. 688 (1990), which involved the application of a state sales and use tax on the sale of religious materials. The California Court of Appeals had ruled that a California tax on the sale of religious books, tapes and other merchandise by Jimmy Swaggart Ministries is valid since it does not violate the Free Exercise or the Establishment Clauses of the Constitution. In a unanimous ruling, the Supreme Court upheld the State Court.

After several years in the courts, the Supreme Court finally brought the Abortion Rights Mobilization (ARM) case to a close by denying ARM's petition to review the Second Circuit Court of Appeals decision that ARM lacked standing to challenge the Catholic Church's exemption from federal income tax. See Abortion Rights Mobilization, Inc. v. United States Catholic Conference, 885 F.2d 1020 (2d Cir. 1989), cert. denied 110 S.Ct. 1946 (1990).

In United States of America v. Church of Scientology of Boston, Inc., and Antonia Chrambanis, Secretary, M.B.D. No. 90-302-T (June 18, 1990), the United States District Court for the District of Massachusetts, in a case of first impression, denied the government's petition for the enforcement of a summons in the context of a church examination subject to the church inquiry and examination procedures

of IRC 7611. The District Court found that the Service failed to show a legitimate purpose for its tax inquiry and failed to establish that its receipt of such documents was necessary as required under the standards for summons enforcement as modified by IRC 7611. The District Court also noted United States v. Church of Scientology Flag Service Org., Inc., 90-1 U.S.T.C. 50,019 (M.D. Fla. December 22, 1989), in which these same issues of summons enforcement in the context of a church inquiry and examination under IRC 7611 are under consideration.